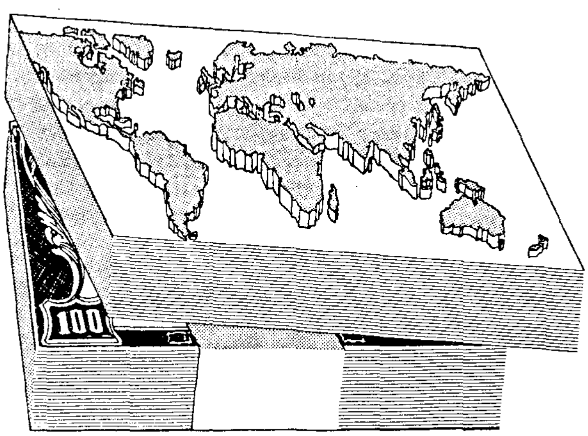
Love, Jim and Ashcroft, Brian and Dourmashkin, Neil and Brooks, Richard and Draper, Paul and Dunlop, Stewart and Malloy, Eleanor and McGregor, Peter and McNicoll, Iain and McFarland, Mark and McRory, Eric and Perman, Roger and Swales, Kim and Stevens, Jim and Yin, Ya Ping and , Fraser of Allander Institute (1991) The world economy [December 1991]. Quarterly Economic Commentary, 17 (2). pp. 3-5. ISSN 0306-7866 ,

THE WORLD ECONOMY



MACROECONOMIC TRENDS

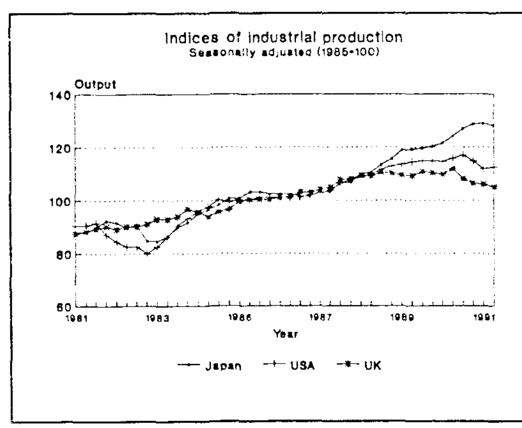
In the second quarter of 1991 there was a further sharp decline in GDP growth among the leading industrialised countries. Comparing the second quarter of 1991 with the corresponding period last year, average growth in the G7 countries was 0.6%, compared with 1.1% in the year to the first quarter. A sharp decline in GDP growth was recorded in Germany, and the UK continued to perform most poorly among its G7 counterparts. Individual country growth rates were as follows (Q2 1991 on Q2 1990): Canada -1.5%; US -0.9%; Japan 5.0%; France 1.6%; Germany 4.2%; Italy 0.7% (year to March); UK -3.6%.

Despite the continuing slackness in GDP growth, there is some evidence that industrial production in the industrialised countries picked up in the second quarter following a very sluggish first quarter. In the year to July industrial production in the OECD declined by 0.3%, and by 0.5% for the G7 countries. In both cases this is a considerably slower rate of decline than in the year to April. The most striking feature, however, is the virtual stagnation of industrial output in Japan and its rapid slowing in Germany, while most other G7 countries improved their rate of industrial output. Individual countries as follows (year to July unless otherwise stated): Canada -4.4%; US -2.1% (August); Japan 0.3% (August); France 0.2%; Germany 2.0% (August); Italy -3.6%; UK -1.8%.

Consumer price inflation continues to moderate. The average annual rate in August was 5.9% for the OECD as a whole and 4.0% for G7 countries (down from 4.7% in May). All G7 countries experienced a modest decline in consumer price inflation in this three month period, except Germany whose rate of inflation rose sharply to 4.1% in the year to August and now lies above the G7 average. Consumer price inflation in the other G7 countries was as follows: Canada 5.8%; US 3.8%; Japan 3.3%; France 3.0%; Italy 6.3%; UK 4.7%. The spread of annual inflation rates in the G7 is now only 3.3 percentage points, the narrowest for a considerable time.

In the three months to August there was very little change in the standardised rate of unemployment among the major industrialised countries, with the G7 average falling fractionally to 6.5%. The only substantial increase occurred in the UK, where the rate of unemployment rose from 9.2% in May to 10.0% in August. Standardised unemployment rates in the other G7 countries in August were as follows: Canada 10.5%; US 6.7%; Japan 2.2%; France 9.5%; Germany 4.6%; Italy 10.0% (April).

United States



Much of the cautious optimism about the US economy which was being voiced a few months ago has now given way to serious concern that the recession is not yet over. Problems began to become apparent when the composite index of leading indicators was static in August following steady increases in the previous six months. This was immediately followed by the purchasing managers' index for September which indicated continuing growth in industrial output, but at a declining rate. Speculation about possible tax cuts were fuelled when the White

House began to speak of a 'growth package' to reduce the burden of taxes on Middle America and help stimulate consumer demand which remains weak.

Concerns over the possible impact of such tax cuts has led to the 'growth package' idea being shelved, but the release of third quarter GNP data did little to remove the gloom over the economy which is now becoming the norm. At first sight the GNP figures appear promising; 1.7% growth in the third quarter following three consecutive quarters of decline. However, there are two reasons why this performance is less satisfactory than it first appears. First, the US economy normally grows very vigorously immediately following a recession, and growth of 2.4% in the third quarter is rather less than had been hoped for to achieve 2-3% growth for the year overall. Second, and of more importance, is the nature of the growth which has been achieved. Half of the quarterly increase resulted from a sharp slowdown in inventory (stock) liquidiations by the industrial sector, which is unlikely to provide more than a temporary boost to growth. Consumer spending and house construction, traditional sources of growing GNP, remain very sluggish.

Fears have thus begun to be voiced that the recovery will stall in the fourth quarter or that growth may even be negative. With fiscal measures ruled out because of the budget deficit, the hopes of continuing the economy's revival rests once again with monetary policy. An unusually low core inflation rate (little over 2% in the year to September) allowed a further 0.5 percentage point in the Federal Reserve's discount rate, the fifth decline in less than a year, lowering the rate to 4.5%. The difficulty will arise if even this is not enough to keep the recovery going. The discount rate is now at an eighteen-year low, and it sems unlikely that it can be reduced much further to stimulate demand.

Meanwhile there is much speculation and rancour over why bank lending remains so depressed. One theory refers to a 'credit crunch' with ultra-cautious bankers unwilling to lend to creditworthy customers who would be only too willing to stimulate the economy given the chance. Others argue that the problem is one of demand, with many individuals and businesses still heavily geared following the credit boom of the late 1980s, and so requiring yet lower interest rates in order to stimulate demand for borrowing. Whichever is correct, once again the beleaguered American banking system tends to take the blame and the strain.

Japan

The Japanese continue to be obsessed with two issues; a slowing economy and a growing trade surplus. Industrial production began to fall sharply in the late summer, down 2.5% in August with only a very modest 0.2% increase in September, norrowly avoiding the first quarterly fall in Japanese industrial production for seventeen years. Most of the leading and coincident economic indicators for Japan are now firmly on a downward path. Meanwhile, Japan's trade surplus has been rising rapidly, and by October stood at $63.5 billion for the first ten months of the year. This is almost 40% higher than the corresponding period last year, and is well on course to equal the 1986 record annual surplus of $82.7 billion.

The idea of a Japanese 'slump' has to be seen in perspective. The economy is expected to grow by 3-3.5% in 1992, relatively slow by recent Japanese standards but more than acceptable to other major industrialised countries. Nevertheless, there are signs of weakness; corporate profits are falling, demand for housing is weakening, and there is now some evidence of a decline in consumer spending. During October and early November this led to repeated requests from the business community for lower interest rates to stimulate the domestic economy, calls which were heeded in mid-November when the official discount rate was reduced by a further 0.5 percentage points to 5%.

Even this failed to satisfy some businessmen, reared on decades of cheap money, who still believe that interest rates are too high and that their profits will suffer further. The government, however, is unlikely to deviate from its path of reducing the discount rate only gradually, arguing that industry is unduly pessimistic and that there is little real possibility of a 'growth recession' (in Japanese terms, annual GNP growth of below 3%).

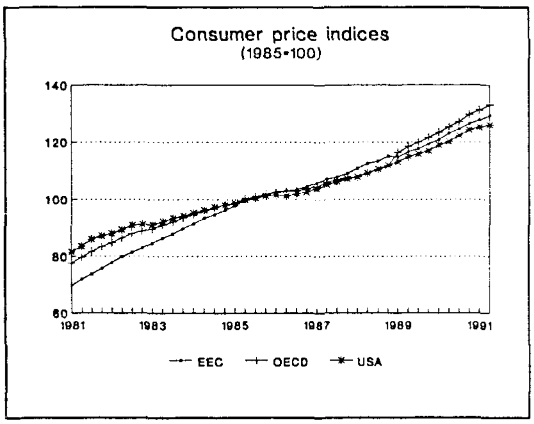
A potentially more pressing problem is the rapid rise in the Japanese trade surplus back to the levels which caused friction in the mid 1980s, especially with the United States. This is, of course, closely linked to the slowing of the Japanes economy. Only when the economy is growing rapidly do the Japanese turn in large quantities to the luxury foreign imports which make such a difference to the trade balance, and when the home market is sluggish manufacturing industry naturally redoubles its efforts in important export markets such as the United States and Europe. In October Japanese exports rose by 6.7% while imports fell by 9.9%, and the country's trade surplus with both the US and EC rose. If the recent decline in the official discount rate does have some stimulating effect, then there may be some beneficial effect on the growing trade surplus, but the government now recognises that more is required. A promotional campaign entitled "Global Partnership" was recently announced, designed to encourage major companies to increase imports. The government has indicated, however, that it expects such a campaign to take several years to have any noticeable effect on trade patterns; it seems unlikely that Japan's major trading partners will wait that long before demanding further corrective action.

Germany

It is still difficult to conceive of Germany as a country possessing economic difficulties of anything other than a mundane nature, but the continuing problems caused by

East-West unification now means that this is the case.

There is at least some good news relating to the east of the country, with the five German economic institutes saying that the economic collapse there has now ended with some evidence of recovery. It is now estimated that in the first full year since **monetary** union industrial output in East Germany fell by 43%, with substantial monthly fluctuations in recorded industrial output still occurring in many sectors. The economics institutes now expect overall output in the east to rise by 10-12% in 1992, although they point out that this is more of a technical recovery following a steep decline rather than the beginning of a sustainable upturn. Unemployment in the east, now standing at just over 1 million, is forecast to rise to a peak of 1.5 million by the middle of 1992, although this does not take account of the labour market shakeout caused by previously underemployed East Germans coming on to the labour market.



The problem for the whole of Germany still springs from the financial strains of the adjustment process following unification. The demands on the federal budget of the aid and tax subsidies paid to the east are very substantial, and are now causing serious concern regarding the future growth and inflation rate of the united Germany. During the year to October, total federal and local aid rose by 24%, much of it becauser of aid pouring into the east. As a result of this, the federal government has agreed to cut such subsidies by 8% in the next fiscal year, although the subsequently-fixed federal budget assumed a total increase in public spending of 2.9%. In addition, a recently-sluggish export performance and a surge of imports for the reconstruction of the east led to a deficit on the current account of the balance of payments in September of DM3.4 billion, and a total of DM32.5 billion for the first nine months of the year. This is in sharp contrast to years of German current account surpluses.

An inflation rate hovering around 4%, slightly above the G7 average, is unacceptable by German standards, and there is now genuine concern of a wage-price spiral beginning. This is especially the case in the east, where wages are on average 50-60% of that in the west and where workers are making vociferous demands for equality with the west. If these are conceded, there is a danger of undermining the competitiveness of the newly-privatised companies thus destroying the faltering industrial recovery, and of adding to the federal debt burden just at the time when it is becoming less equipped to cope with the inflationary pressures which this would generate.

PROGNOSIS

The pattern of growth exhibited by the major industrialised countries is beginning to change from that which has been apparent for the last two years. Germany and Japan, the principal areas of growth, are both now experiencing problems which will prevent them combining the desirable elements of rapid growth and low inflation for the foreseeable future. Meanwhile, the US and UK economies show little sign of a rapid movement out of recession much less the rapid growth necessary to maintain average G7 growth at the level which was apparent in the late 1980s.